(21)

In the Supreme Court of the United States

OCTOBER TERM, A. D. 1944.

No. 496.

In the Matter of
THE HIGBEE COMPANY, *Debtor.*
BANKRUPTCY
No. 36,119.

THE TERMINAL AND SHAKER HEIGHTS REALTY CO.,
Petitioner,

vs.

CHARLES L. BRADLEY and
JOHN P. MURPHY,
Respondents.

PETITIONER'S REPLY BRIEF ON PETITION FOR WRIT.

ROBERT J. BULKLEY,
JAMES A. BUTLER,
Bulkley Bldg., Cleveland 15, Ohio,
ROBERT W. PURCELL,
Terminal Tower, Cleveland 13, Ohio,
Attorneys for The Terminal and Shaker Heights Realty Company.

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Cases.

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Three important and very interesting questions of law growing out of the administration of bankruptcy reorganization proceedings involving two large companies are presented in this case.

Respondents' brief deals entirely with the findings of fact as made by the Master and confirmed by the District Court and the Circuit Court of Appeals. We do not now question any facts thus judicially established. Our petition for writ of certiorari is based exclusively on the error of the lower courts in dealing with facts found to exist in this case. This decision of the Sixth Circuit Court is in conflict with the holding of the Second Circuit Court of Appeals in the case of *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121, in that it permits a subsequent judicial determination to justify an exception to the rigid rule of loyalty demanded of corporate officers and directors. The important questions raised in this case, relating to bankruptcy reorganization proceedings and the conduct of corporate officers involved therewith, matters of great general interest, have not been passed upon by the Supreme Court.

On October 9, 1944, the Supreme Court granted a petition for writ of certiorari in pending application No. 342, entitled *"Young v. The Higbee Co., et al."* That case was argued consecutively to the instant case in the Circuit Court of Appeals. It involves facts which respondents have sought to use in this case. The issue in case No. 342 is whether or not J. F. Potts and William Boag, preferred stockholders of the Higbee Company, have the right to keep for themselves the proceeds ($100,000) of the sale to Bradley and Murphy of their appeal against confirmation of the Higbee reorganization plan, then pending in the Sixth Circuit Court. One of the grounds on which Bradley and Murphy in the instant case based their defense of estoppel was their payment of that large sum to Potts and Boag to buy off an appeal, which, if successful, would have benefited all preferred stockholders.

These two cases are intimately bound together. They concern, from different aspects, the same facts growing out of the Higbee Co. bankruptcy reorganization. Wisely, this Court has determined to hear case No. 342 on its merits. A complete determination of the pending questions growing out of the Higbee reorganization, involving all the parties to the transaction which is the subject of the litigation in case No. 342, will require the Court to hear this case on its merits. This case might well be heard either concurrently with or consecutively to case No. 342.

ANALYSIS OF RESPONDENTS' BRIEF.

We offer the following comments on respondents' "Statement of the Case":

(1) The Fiduciary Relationship.

We take issue only with the last two paragraphs on page 3. Respondents assert as a fact found by the Master that "Midamerica had nothing but a nominal interest in CTB (The Cleveland Terminals Building Co.) on May 15,

1937." Reference to the Master's finding 29, as cited, clearly shows that it was not a finding of fact based on any testimony in this case, but a conclusion drawn from a decision of the Sixth Circuit Court of Appeals on April 16, 1941. Thus we are squarely confronted with the question posed in our opening brief, whether as a matter of law a subsequent adjudication of the extent of a corporation's interest may be used to justify conduct of a corporate officer in assuming a position in conflict with the interest of his corporation.

The full text of Master's finding No. 29 (R. 498) follows:

> "29. The decision of the Circuit Court of Appeals on April 16, 1941 (*In re Van Sweringen Company,* 119 F. (2d) 231) holding that the second mortgage was valid as a claim against The Cleveland Terminals Building Company for only $2.00 and that the $13,787,000 claim against the Van Sweringen Corporation was valid as a claim against The Van Sweringen Corporation for only $887, determined that Midamerica never had anything other than a nominal interest in The Cleveland Terminals Building Company."

For the propositions that CTB "had no equity in the building" and that "the real owner of the building together with the lease and rentals was the Metropolitan Life Insurance Company" Master's finding No. 32 is cited. This finding, in fact, shows that CTB *did* have an equity in the Higbee store building subject to a security assignment to the Metropolitan Life Insurance Company. But the Master adds that the "equity has subsequently been determined to be of no value." When and by whom the "subsequent determination" was made, the Master fails to tell. Surely he made no finding that the equity had been determined to be valueless on May 15, 1937. Again we are confronted with the question as to what may be the legal effect of a "subsequent determination" concerning the extent of a corporation's interests, and how far such "subsequent

determination'' may justify the conduct of a corporate officer in assuming a position presently adverse to his corporation.

The full text of Master's finding No. 32 (R. 498) follows:

> ''32. The only interest which The Cleveland Terminals Building Company had in The Higbee Company or in the Higbee store building, during the time involved in this controversy, consisted of an equity in the Higbee store building which was subject to a first mortgage to The Metropolitan Life Insurance Company of upwards of Ten Million Dollars,—the lease with The Higbee Company, together with all past due and unpaid rentals, having been assigned to The Metropolitan Life Insurance Company as a part of the security for the mortgage debt. This equity in the Higbee building has subsequently been determined to be of no value.''

(2) Estoppel.

Assuming as true all the facts as stated by respondents under this heading, we find no allegation which shows a legal detriment to Bradley and Murphy arising from Midamerica's demand that their past due note be paid in accordance with its terms. True, there is a purported ''finding of fact,'' No. 46 (R. 501) by the Master, that Bradley and Murphy changed their position for the worse, but obviously this must be a conclusion of law. What they say they did was to borrow money elsewhere to pay in full their past due note. Surely, they suffered no legal detriment in changing creditors in order to meet a past due obligation.

The full text of Master's finding No. 46 (R. 501) follows:

> ''46. Bradley and Murphy reasonably relied upon said notice in writing and acted thereon so as to change their position for the worse.''

But respondents say that the borrowing of the money was "among other things." The citations that follow (F. 50, F. 51, F. 52, R. 502) show that the "other things" consisted of employing counsel to resist Midamerica's demand for payment of their admittedly past due obligation; of purchasing stock from Potts and Boag, and of causing the dismissal of the appeal which Potts and Boag had taken to the Sixth Circuit Court. The purchase of stock and dismissal of the appeal are the subject matter of Case No. 342 in this Court and are discussed herein below.

(3) Laches.

Respondents' brief quotes from the decision of the District Judge (R. 525-6) wherein he commented upon the delay of four years in the commencement of this action. Although the District Judge may have felt that the time elapsed between the purchase of the Higbee securities by Bradley and Murphy and the commencement of this action by Midamerica was too long, nevertheless, he affirmed the conclusion of the Master that laches did not bar recovery herein.

The Master's Ad Interim report contains conclusion of law No. 14 (R. 506) specifically holding that Midamerica's claim was not barred by laches. The full text of Master's conclusion No. 14 (R. 506) follows:

> "14. Section 77B (b) and Section 261 of Chapter X of the Bankruptcy Act as to reorganizations of corporations provide that all periods of time prescribed by statutes of limitation shall be suspended during the pendency of a reorganization proceeding. This is applicable to this proceeding, so that the bar of a statute of limitations by laches or otherwise is not enforceable in this proceeding."

The opinion of the District Judge expressly approves all findings of fact and conclusions of law made by the Master in the following language (R. 526):

"I think that the findings and conclusions of the Master are adequately supported and respond to the evidence, and they are approved and adopted and the report confirmed."

These findings and conclusions were reaffirmed by the District Court's ruling as expressed in its Journal Entry finally disposing of this case on March 16, 1943 reading in part as follows (R. 530):

"It is therefore ORDERED, ADJUDGED AND DECREED that:

1. The ad interim report of the Special Master heretofore filed herein, is hereby, in all respects, ratified, approved and confirmed, and the objections and exceptions filed thereto are overruled."

Therefore, the argument on page 27 of Petitioner's main brief is a correct and accurate statement. The Circuit Court did overrule the District Court on the question of laches, although respondents took no exception to the order of the District Court cited above.

Midamerica, through its counsel, was closely following the progress of the Higbee reorganization and relied upon the rulings of the Special Master concerning claims to these Higbee securities, all as more fully set forth on pages 28 and 29 of petitioner's first brief. Obviously Midamerica was not "ordered" to withhold asserting its claim. Respondents' characterization of our position at the bottom of page 12 of their brief, and the ensuing discussion distort petitioner's contentions.

Conflict of Interest.

In its opinion the Circuit Court did not sustain respondents' contention that there was no conflict of interest. On the contrary, the court's opinion (R. 566) says:

"If CTB had any substantial interest in this matter, and if its claim were not barred by estoppel and laches,

we think that a substantial conflict of interest would have been created between the parties."

In so far as respondents now advance the argument that a conflict of interest did not exist, it is they who are asking for a review of the findings of the court. Our argument assumes that a conflict of interest existed, but for the three legal points specifically mentioned in the court's opinion, which are the three points we have just discussed, and now seek to have reviewed by this Court.

From the language in the opinion it appears that the Circuit Court's conclusion that there was a lack of substantial interest, was based upon a subsequent adjudication. The question of conflict of interest should be determined on the basis of the situation as it existed at the very time that Bradley and Murphy bought the Higbee securities, namely May 15, 1937. True, at that time CTB was in arrears as to mortgage interest and had assigned the Higbee lease to the Metropolitan Insurance Company as additional security for the mortgage on the building. However, as soon as Bradley and Murphy, by their purchase of the Higbee securities identified themselves with the Higbee interests for lower rents, as against the CTB interests for higher rents, the Special Master in charge of the CTB bankruptcy reorganization proceedings moved to have CTB's interest protected by the appointment of independent counsel. The District Court thereupon appointed Walter Sharp as independent counsel for CTB. This action of the court clearly shows that in the situation as it existed at the time, there *was* a conflict of interest.

The officers thus placed themselves in a position which was judicially determined *at the time* to be in conflict with the interests of their corporation. To hold that such conduct could be justified by the *subsequent* defeat of Midamerica's claims, direct and indirect, against CTB and Higbee, is to give them a personal interest in defeating

the claims which their own corporation was asserting. Such a rule accomplishes the utmost possible of disintegrating erosion against the principle of undivided loyalty of corporate officers to their employers. It is unprecedented, unsound and immoral to hold that the subsequent defeat of a corporation in litigation pressed in good faith, can be a justification to corporate officers for taking a position which they must have known at the time to be adverse to their corporation.

The Sixth Circuit Court in the instant case declined to hold Bradley and Murphy accountable to petitioner on the ground that Midamerica's interest in the situation was "not substantial," because of two decisions by the same Sixth Circuit Court; one in the case of *Higbee Co. v. Cleveland Terminals Building Co.*, 106 F. (2d), 796, decided two years after the cause of action in the instant case arose, and the other in the case of *In re Van Sweringen Company*, 119 F. (2d) 231, decided four years after this cause of action arose.

Further reference seems justified to the extraordinary contention made at the bottom of page 6 of respondents' brief. This refers to the adjudication by the Sixth Circuit Court in 1941, in *Re Van Sweringen Company*, 119 F. (2d) 231, reducing certain claims owned by Midamerica to nominal amounts and holding that, "*in the hands of Midamerica* they never represented more than a nominal interest." (Italics ours.)

The Circuit Court there gave as reason for the disability of Midamerica in this respect, that in its inception Midamerica was made the instrumentality of certain financial interests to regain for their own use, and at the expense of their creditors, a lost railroad holding company empire, by the purchase of securities at a sale forced by J. P. Morgan & Co. The Van Sweringen brothers and their associates, having secured new financial backing, were found to have deserted the corporations to which they owed a loyalty and to have acquired the securities at bargain prices for

their own personal interests through the instrumentality of Midamerica, which they had caused to be incorporated for that purpose. It was this transaction that the Circuit Court held created a disability to Midamerica in asserting its claims. Among those named in that decision of the Circuit Court as having been associated with the Van Sweringens in the disloyalty which disabled Midamerica, were *Charles L. Bradley* and *John P. Murphy.* The same Bradley and Murphy now rely upon that decision to relieve them from the consequences of assuming a conflicting position in 1937.

SUPREME COURT CASE 342.

In November, 1941, J. F. Potts and William W. Boag, who owned preferred stock of Higbee and who purported to represent preferred stockholders generally in the reorganization proceedings, appealed from the order of the District Court which had approved the Higbee plan of reorganization. There were several grounds for the appeal, among which were the following:

First, it was urged that the junior indebtedness of Higbee, upon which Bradley and Murphy had filed their claims, should be considered a capital contribution to Higbee, because it represented an advance by CTB made in 1931—when Bradley was President of CTB—while Higbee was controlled by CTB.

Second, it was urged that in the alternative, pursuant to the rule of *In re Van Sweringen Company, supra,* the junior indebtedness should be allowed only in the amount of $100,000 because that was the amount which Midamerica had paid for the junior indebtedness when J. P. Morgan & Co. foreclosed and sold it at auction on September 30, 1935 —Bradley being at the time a director of both Midamerica and of Higbee.

Third, as a second alternative it was urged that, pursuant to the same rule, the junior indebtedness upon which Bradley and Murphy had asserted their claim should be allowed against Higbee for no more than $600,000, that being the purchase price which Bradley and Murphy had agreed to pay for it—Bradley being at the time a director of Higbee.

(The foregoing appears at pages 182 and 183 of the transcript of the record in case No. 342, now pending in the October, 1944, term of this Court. Bradley and Murphy were parties in that case below.)

Apparently Bradley and Murphy felt that their interests required that these contentions be disposed of without final judicial determination. Therefore on March 7, 1942, Bradley and Murphy paid Potts and Boag $115,000 for the 260 shares of Higbee preferred stock then owned by Potts and Boag, which had a market value of approximately $15,000. Bradley and Murphy thus came to control the appeal which Potts and Boag had theretofore perfected and they promptly caused its dismissal, in complete disregard of the interests which other preferred stockholders had in that appeal. Potts described the transaction as "selling the appeal." (R. 188 in case No. 342.)

On October 9, 1944, this Court granted a petition for writ of certiorari in case No. 342 (Robert R. Young v. The Higbee Co., *et al.*) and will hear and determine the question of the propriety of the conduct of the parties to that transaction. Bradley and Murphy were directors of Higbee, a debtor in reorganization proceedings,—and thus in a very real sense officers of the court—at the time they made this payment to Potts and Boag. In No. 342, this Court will consider the conduct of Potts and Boag, appellants in behalf of preferred stockholders in "selling the appeal" for their own benefit. In the instant case this Court should consider the conduct of Bradley and Murphy, officers of The Higbee Co. and of the Bankruptcy Court, in buying the same appeal for their own purposes.

The legal detriment which Bradley and Murphy claim and which at page 11 of respondents' brief they state caused an estoppel, resulted from the payment of the $100,000 bonus to Potts and Boag to bring about a dismissal of the appeal. A similar contention was strenuously urged below. The Circuit Court regarded this purchase of the Potts and Boag stock and the consequent dismissal of the appeal as a legitimate, proper transaction. However, if upon a hearing of case No. 342 this Court should reverse the Circuit Court and hold that the purchase from Potts and Boag under the circumstances, and the subsequent dismissal of the appeal, constituted an unlawful transaction in which Bradley and Murphy participated, then the ground for equitable estoppel asserted by Bradley and Murphy would be eliminated.

This is a case in equity to impress a constructive trust. The Circuit Court balanced the equities and refused to impress the trust. One of the important equities relied upon by respondents was the detriment incurred because they paid a bonus to Potts and Boag in a transaction which the Circuit Court approved. Should this Court reverse the Circuit Court in case No. 342, then that equity which the Circuit Court found to be in favor of Bradley and Murphy would no longer exist. In order to do justice to the parties here, this Court should also review the decision of the Circuit Court in the instant case.

CONCLUSION.

Respondents' conclusion makes a final attempt to persuade this Court that petitioner is seeking a re-examination of the facts involved in this litigation. That is not our purpose. Petitioner contends that under the facts as they have been judicially determined in this case, the Circuit Court has improperly applied the law with the result that this judgment of the Sixth Circuit Court is in conflict with the Second Circuit Court of Appeals in the case of *Irving Trust*

Co. v. Deutsch, 73 F. (2d) 121. The Second Circuit Court holds fiduciaries strictly accountable to their cestuis and allows no exceptions to that rule.

The questions presented in this petition for writ of certiorari are important and it is in the public interest to have them decided by the Supreme Court. Dealing as they do with bankruptcy reorganization proceedings, they concern business generally. The overreaching conduct of corporate officers serving during the course of bankruptcy reorganization, under the administration of the courts, is a matter of great concern which should now be passed upon by the Supreme Court. Petitioner requests this Court to grant a writ of certiorari to the Sixth Circuit Court of Appeals in this case.

Respectfully submitted,

ROBERT J. BULKLEY,
JAMES A. BUTLER,
ROBERT W. PURCELL,
Attorneys for the Petitioner.